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The Manufacturers Hanover
Economic Report

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The Tail Wags The Dog

Time was when economists paid literally no attention at all to our foreign trade position when analyzing and forecasting the gross national product. It's not hard to see why: Although exports have accounted for about 6½ percent of the real gross national product in the postwar era, imports equalled more than five percent on average, so the actual contribution to the economy—what economists call net exports—was a relatively minor 1½ percent. Since this was well within the range of error insofar as forecasting GNP levels is concerned and, because its small size meant it didn't have much of an impact on the quarterly changes in the GNP, few economists made any serious attempts to forecast net exports—much less analyze and understand them.

All this has changed. While exports' share of the GNP has remained about the same, imports have shot up to the point where they now exceed exports by a considerable margin. As measured in the GNP accounts, the U.S. ran a deficit in its inflation-adjusted exports of goods and services in each of the first three quarters of 1984 with the deficit growing significantly through the year. Notwithstanding what you may have been reading about our deficit on the balance of payments basis, in the GNP accounts such a deficit is rare. In fact, before this year, the only other time in postwar history that net exports adjusted for inflation were in deficit was in the last quarter of 1971 through the second quarter of 1972. Then, the total amount of red ink in our foreign trade was $2.5 billion (1972 dollars). That was about one-third the size of the trade deficit run during the first quarter of this year alone, when real imports exceeded real exports by $8.3 billion. This proceeded to widen to a gap of $11.4 billion in 1984's second quarter—and then it more than doubled to $27 billion in the third quarter of 1984.

You have to put this into perspective to get the significance of this trade gap. First, as you will recall, the real gross national product which rose at an annual rate of 8½ percent in the first half of this year slowed dramatically to an anemic 1.6 percent pace in the third quarter. Most of this slowing traced to the worsening of our inflation-adjusted net export position. If the trade deficit in the GNP accounts had done no more than remain at the second quarter's record high, the U.S. economy would have grown at a 5.5 percent annual rate in the third—three times as fast as it actually did.

Let me put it another way. Since the third quarter of 1980, when our real surplus on trade was the greatest, inflation-adjusted net exports have declined by $80 billion, a loss equivalent to nearly five percent of the real GNP. Without this decline, the economy would have been 18 percent larger in the third quarter of 1984 compared

EFFECTS OF THE STRONG DOLLAR ON SELECTED INDUSTRIES

	Production Employment (Thousands of Workers)			Trade Deficit (Millions of Dollars)			Imports As A % of Consumption		
	1979	1983	1984: November	1979	1983	1984: August	1979	1983	1984(e)
Automobiles	764	571	665	$11,061	$19,203	$25,011	22.0%	26.0%	23.0%
Communications Equipment (Radio, Television, Telephone)	347	321	343	3,218	7,474	12,149	29.5	41.1	40.0
Iron and Steel Products	380	211	211	6,076	4,924	8,280	15.2	20.5	30.0
Lumber and Wood Products	654	547	594	818	969	1,274	24.9	29.5	29.2
Metalworking and Machine Tools	271	193	219	143	344	793	23.0	32.5	37.3
Paper and Paper Products	535	495	512	1,564	1,324	561	13.0	12.6	14.2
Textiles and Apparel	1,888	1,625	1,671	3,581	9,025	14,053	32.6	45.5	50.0

Sources: U.S. Bureau of Labor Statistics; U.S. Department of Commerce; Ward's Automotive News; American Iron and Steel Institute; National Association of Forestry Products; National Machine Tool Builders Association; American Paper Institute; International Ladies' Garment Workers Union.

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with four years earlier; instead it grew by less than 12½ percent.

As you can imagine, this foregone growth in the economy represents rather substantial losses in sales, earnings, and jobs. The table shows that a number of our key industries have shrunk as a result of either a reduced ability to export or because of competition from abroad. More than two million jobs have been lost because of this deterioration in our foreign trade position.

Even more dramatic is the financial implications of these growing trade deficits. If present trends are not reversed, the U.S. will cease to be a net lender to the rest of the world and will become a net debtor. This will occur when the total value of foreigners' holdings of assets in this country exceeds the value of U.S. assets abroad. The way things are going, this will occur sometime in 1985. Shortly thereafter, assuming a continuation of present trends, our foreign debt will exceed those of Brazil or Mexico, currently the world's largest debtors. And if nothing changes in the next few years, our net external debt could approach $1 trillion by the end of the decade—more than the total owed today by all the developing countries in what is called "the debt crisis."

This is more than just an abstract notion. Instead of earning money annually on our foreign investments, we will be paying out money to foreigners with investments here. Of course, these are funds that would not be available for domestic use, but rather, will go abroad.

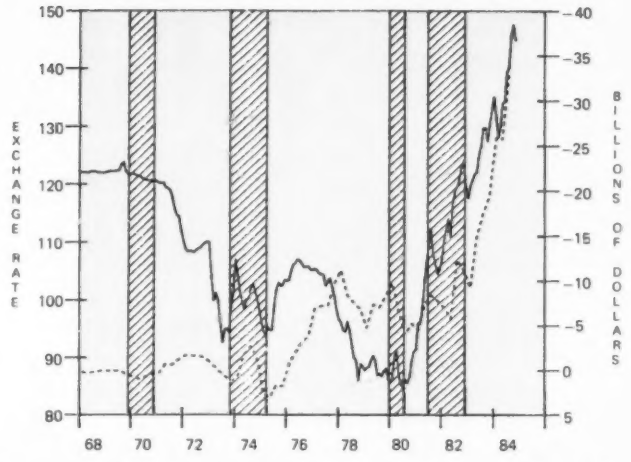
The Overvalued Dollar ...

It's not too difficult to see why our trade position has deteriorated. The U.S. dollar has climbed dramatically in value since the middle of 1980, as you can see from Chart I. On a trade-weighted basis, the dollar's value has climbed by about 70 percent since midyear 1980. It has gone from being an undervalued currency to one that is extremely overvalued. This overvaluation is largely—but not totally—responsible for the sharp turnaround in our trade position. Other factors that have caused our trade picture to deteriorate include the LDC debt crisis and the relatively anemic economies elsewhere in the industrial world.

Let me explain just what an overvalued dollar is, since there seems to be some confusion over this point. Some people would believe that the dollar's value in foreign exchange markets is whatever the markets say it is and that there is no such thing as an over- or undervalued dollar. This is not entirely correct. Because the markets clear at the end of the trading day does not necessarily mean that the various currencies are at their appropriate level any more than the price of any stock might be deemed by investors to be at its appropriate level when the exchanges close.

The best way to look at the position of the dollar is to

CHART I
U.S. DOLLAR TRADE-WEIGHTED EXCHANGE RATE (LINE)
VS. MERCHANDISE TRADE DEFICIT, BOP BASIS (DOT)



compare what can be bought in the U.S. with a dollar with what can be bought overseas. By our calculations, it takes roughly two D-marks to buy in Germany what one dollar will buy in the United States. Yet, in the foreign exchange markets, the holder of a U.S. dollar today can buy more than three D-marks. Plainly, this means that the dollar is overvalued against the mark and the mark is undervalued against the dollar. Here is another example. You can buy goods and services in Britain with one pound sterling that would take a $1.50 to buy in the United States. Yet the pound exchanges for only $1.17 at this writing. Again, the dollar is overvalued versus the pound while the pound is undervalued versus the dollar.

As it translates into world trading markets, it means that goods that are priced in dollars and sold abroad are extremely expensive to holders of marks, pounds, francs, yen, and so forth, while goods produced in those countries are extremely low in price when brought into the United States. One may argue over what method to use when calculating over- or undervaluations of currencies, but the bottom line is that the U S. trade position deteriorated soon after the dollar's value began to climb.

... Boosted By High Real Interest Rates ...

Having, I hope, settled this question, the next point that might be asked is what caused the dollar to rise as rapidly as it did? There may be a number of reasons why people will invest in dollars such as our strong economy, political stability, large and fluid financial markets—not to mention the freedom to move money in and out of the country at will. But these factors have always existed, yet the dollar was not always overvalued. Clearly, it would appear that there are other factors.

The first is the increased after-tax profitability of investments that has resulted from the 1981 change in tax depreciation rules. Second, there was the decline in the rate of inflation, which substantially reduced the effective tax rate on income earned on these investments.

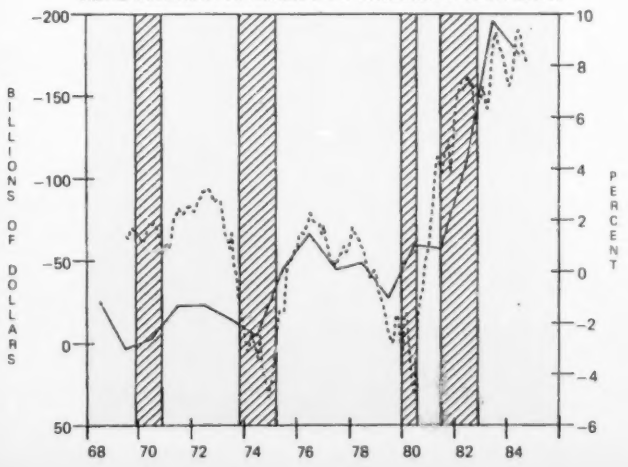
Meanwhile, sluggish recoveries elsewhere and higher costs have lowered pre-tax profitability in other countries to below that of the United States.

However, the key reason for the strong dollar seems to be the rise in real interest rates that has occurred over the past 4½ years. In turn, these appear to trace to the large actual and projected deficits in the Federal budget (Chart II). These deficits, of course, represent a need on the part of Washington to borrow in order to close the gap between spending and revenues. Not only are these deficits the largest in history in dollar terms, they represent the biggest share of GNP in the postwar era and the biggest chunk of net national savings as well. This alone would suggest that interest rates would have to be high in order for the Government to crowd out the private sector from the financial markets so that it could borrow to finance its needs. At the same time, however, the Federal Reserve changed its monetary policy from one that allowed inflation to one that has brought it down. Thus there was even less of a pool of credit available for Washington to borrow from than there might have been had the Fed continued to pursue its previous policy.

... Should Be Brought Down

The next question is what do we do about it? If our only focal point were the dollar's impact on economic growth, specific industries and jobs, there would be no question but that we should take steps which would depress the value of the dollar as quickly as possible. Since it has been established that high real interest rates are the cause of the strong dollar, it would seem logical that one way or another these real interest rates should be brought down. Because the Federal Reserve can influence the level of interest rates, the suggestion might be made that the Fed should pump more liquidity into the economy. This would undoubtedly lower both nominal and real interest rates. And if this increase in liquidity should produce more rapid rises in prices, then real interest rates would fall further, thereby reducing the attractiveness of holding dollars to foreigners and, in turn, causing them to get out of dollars and back into their currencies. All would presumably come out all right as imports became more expensive, exports more competitive, with the subsequent fillip to the U.S. economy.

CHART II
FEDERAL BUDGET DEFICIT (LINE) VS.
REAL INTEREST RATE ON 7-YR TREASURY NOTE (DOT)



But it's not as easy as all that. Too-rapid a fall in the dollar could not only take it back to an undervalued position, it could result in a new round of double-digit inflation, as a byproduct. For just as the strong dollar has helped reduce the rate of inflation by a substantial amount, it would be logical to expect that a weakened dollar would result in more rapid inflation. And if this were not enough, one must remember one key result of the dollar's rise in the first place: Its attractiveness to foreigners enabled Washington to finance some of its deficit abroad rather than in domestic markets. In effect, we would seem to be between Scylla and Chrybdis, when it comes to policy regarding the foreign exchange value of the dollar.

In my view, there is a way out. If interest rates were to fall because of reduced demand for funds by Washington to finance its deficit and not because of more money created by the Federal Reserve, I would bet that the dollar would float gently downward like a snowflake, rather than falling like a ton of bricks. My reasoning is simple: We would still be a low-inflation economy, one whose growth potential would be enhanced if Washington's borrowing needs were reduced, thus freeing up funds for the private sector. In this circumstance, there might not be as much additional foreign money coming into the U.S. as before —but at least it would not flee the dollar as might be the case were inflation perceptions to change in the wake of an extremely easy monetary policy. And whatever slowdown there would be in funds coming in from abroad might well be made up for by the reduced level of Government borrowing that would accompany a shrinking budget deficit.

If this sounds like another plea for Washington to get its act together and start working on balancing the budget, you are right. Sooner or later the tail will stop wagging the dog; the dollar will decline. If the Administration and the Congress can come up with a package that produces a balanced budget within a few years, this decline will not only not be injurious to the U.S., it will be helpful.

Let us hope that the New Year will bring a new attitude towards reducing the budget deficit on the part of our elected officials in Washington. If it does, it will truly be a Happy New Year for all.

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Business Conditions Update

By now, it should be clear to all but the most die-hard pessimists that the U.S. economy managed to skirt a recession last year and is once more on a fairly solid growth path. Not only was the Commerce Department's estimate of the increase in the fourth quarter's real gross national product nearly 40 percent higher than reported in the so-called "flash" GNP estimate, it was one and a half times the rate of rise in the third quarter. As pointed out in the October 1984 Economic Report, this speedup in growth in the fourth quarter provides a good jumping-off point for 1985. This jumping-off point is even higher than it looks, since monthly data suggest that economic growth accelerated toward the end of last year and continued early this year. This virtually ensures that 1985 will be another good year for the economy, when annual growth averages are taken into account. However, it would be a mistake to assume that the quarterly pattern of growth in 1985 will duplicate that of 1984, when growth was extremely strong in the first half of the year, weakening in the second.

Inventories and Foreign Trade ...

For one thing, inventory accumulation is not likely to contribute to GNP growth the way it did a year ago. Last year at this time there was a feeling in the business community that inventories had gotten too low relative to current and projected sales. In addition, there was a belief in some quarters that the rate of inflation would accelerate as it used to do during business expansions, providing another reason to stock up on goods. Business plans for investment in plant and equipment were strong and this sent a signal to a wide variety of industries to prepare for these demands. As measured in the GNP accounts, the change in business inventories in last year's first quarter added 6.5 percentage points to economic growth—nearly tripling the 3.6 percent rate of rise in real final sales.

This year is somewhat different. For one thing, retailers are shell-shocked from their experience during the 1984 holiday shopping season. In order to move merchandise many stores had to offer substantial discounts from intended selling prices. Merchants were left with large amounts of unsold goods which many are still trying to work off. This discounting, along with the low rate of inflation posted for 1984, has clearly changed the psychology from buy in advance to wait for lower prices. Business spending plans for capital goods may be positive for this year but they are certainly nowhere near as ebullient as they were in 1984. Finally, the demand for finished goods appears to be settling into a long-term trend rate of growth, since pent-up demands from both business and consumers that developed during the recession appear to have largely been satisfied—at least at current prices.

... Will Influence Quarterly Growth Rates

In addition, there would appear to be another reason not to expect the economy to bounce back smartly. This stems from our foreign trade position. As was pointed out in the December 1984 Economic Report, the unprecedented strength of the dollar has caused foreign trade to exert a major influence on our economic growth. The GNP table shows that, while growth in final sales in the fourth quarter compared with a decline in the third helped to boost overall GNP growth, another reason for the turnaround can be traced to the drop in our foreign trade deficit—which, of course, is less of a subtraction from the total real GNP. If the trade deficit in the fourth quarter as measured in the GNP accounts had equaled that of the third, real GNP would have gone up by only one percent instead of the nearly four percent it did because this was the rate of growth in real domestic demand. This can be seen in the GNP table, since we are including real domestic demand for the first time right underneath real final sales. Note, by the way, that by removing the effects of foreign trade, you can see that real domestic demand grew at a progressively slower pace during 1984.

While we are expecting a pickup in real domestic

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demand during the current quarter, we think that this will be offset by a widening of the trade deficit. This is because the dollar today is stronger than it was in the fourth quarter—and it was extremely strong in the fourth quarter, anyway. It is difficult to say with certainty why our trade deficit shrank in the fourth quarter compared with the third at a time when the dollar was strong. I would think, however, that it reflected the earlier slowdown in final sales. If this is the case, then the fourth quarter's pickup in final sales should result in a greater influx of imports during the current quarter, leading to the widening of the trade deficit depicted in the GNP table. In other words—the influence of foreign trade has to be taken into account when forecasting much more so than used to be the case. And if recent trade patterns are any guide, overall GNP growth could oscillate more than it used to.

Another contributor to this roller-coaster economy is the relationship between fiscal and monetary policy. Because fiscal policy appears to be locked in the full-throttle position, the role of controlling the economy has been assumed entirely by monetary policy. The Federal Reserve seems willing to let interest rates go up when economic growth gets strong—but is quick to push them down when growth appears to be stalling. Since economic data are available with a lag and since the economy responds to changes in interest rates with a lag, you can see another reason why the economy has adopted this stop-go characteristic.

The Federal Reserve Will Remain Generous ...

I would like to point out, however, that this role as policeman of economic activity is not entirely a new one for the Fed. In actuality, it is similar to the role the Federal Reserve had prior to October 1979. The Federal budget was in surplus only twice in the previous 20 years, so most of the burden of managing the economy had fallen on monetary policy. From October 1979 through midyear 1982, the Federal Reserve shifted to the monetarist approach to conducting monetary policy. This meant it placed greater reliance on controlling the money supply and less on such other factors as interest rates. While both the Fed and the monetarists would agree that this was not an experiment in pure, automatic-pilot monetarism, it certainly was closer to it than anything the central bank had ever done.

The Fed moved away from its monetarist experiment in the middle of 1982, adopting a more eclectic approach to monetary policy. It eased dramatically as the risks of worsening recession appeared to far outweigh the risks of inflation. The Fed thus sent interest rates lower, the stock market higher, and the economy bounding out of recession by the end of 1982. By May of 1983, when it had become apparent that the economy was safely out of recession and firmly entrenched on the recovery road, the Fed let interest rates rise in order to keep this growth from getting out of bounds. As business activity slowed a bit in the second half of 1983 the Fed let interest rates move lower—but the pickup in growth in first-half 1984 saw interest rates once again move higher. The slowdown during summer 1984 was accompanied by another decline in interest rates, setting the stage for the bounceback in the economy toward the end of last year.

This is not to imply that the Federal Reserve is no longer paying attention to the money supply and to the inflationary potential of rapid growth in the money stock. The Fed still issues target ranges and seems to want the money supply to grow within these bands. However, it does not appear as though this is the Fed's primary concern at this time. Nor, for that matter, is inflation. Because the rate of inflation remained low in 1984 and seems likely to do so this year, too, Federal Reserve officials have stated publicly that they are prepared to tolerate more growth than they might have previously. In our view, inflation will remain low as long as the dollar remains strong. If the dollar were to weaken suddenly causing inflation to flare up, the Fed's tolerance for strong growth might diminish.

This brings up the next question: How much longer can economic growth continue, considering the imbalance between fiscal and monetary policy, the huge trade deficit, and the aging of the business expansion which makes it more susceptible to these and other developments than it was last year or in 1983? In my view, economic growth at varying rates will continue until:

- The dollar's strength weakens enough industries to cause the overall economy to lapse into recession, or;
- the dollar collapses, boosting exports and retarding imports, increasing capacity utilization and tightening labor markets. As price pressures develop, interest rates would jump—sending the economy into a recession, or;
- there is an accommodation on the budget between the Administration and the Congress which brings the deficit down and allows a better balance between fiscal and monetary policy. In this case, the path of economic growth would be smooth and the expansion could be quite long lasting.

Obviously, this kind of scenario makes planning ahead extremely difficult. Right now the key consideration for business, labor and investors is the low rate of inflation and how that impacts buying policies, wage and price decisions, as well as investment strategies. But this could change if the dollar's foreign exchange value should suddenly drop. Additionally, the rather large spread between short- and long-term rates continues to induce heavy reliance on short-term debt by the business sector. Businesses raised a lot of money in the short-term markets in 1984, in part a reflection of the lower cost compared with long-term funds. If the yield curve should flatten, business may be tempted to fund out, which would be good, since it would improve the state of their balance sheets.

... As Long As Inflation Stays Down

However, even if the yield curve does not flatten, business may have to finance in the longer term markets, anyway. This is because many banks will not have the appetite for making loans this year that they had in 1984. Bank lending policies will be constrained by the higher capital requirements that have been imposed by the regulatory authorities. It comes just at the point in the economic cycle when business needs for external funds are generally larger than earlier in the expansion, when sales and profits were growing more rapidly.

Therefore, even if the Federal Reserve is more tolerant of economic growth, thus more generous with the supply of money and credit, short-term interest rates may rise, anyway, because of the factors described above. On the other hand, long-term interest rates, which are very sensitive to inflation and the expectation of inflation, could very well trend lower for most of the rest of this year—again, assuming that the dollar remains strong, keeping inflation at bay. H

February, 1985

MHT FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1984				YEAR 1984		1985				YEAR 1985	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	3553.3	3644.7	3694.6	3752.5	3661.3	10.8	3793.6	3860.4	3937.3	4032.8	3906.0	6.7
GNP: $72	1610.9	1638.8	1645.2	1661.1	1639.0	6.8	1665.4	1681.6	1701.6	1725.4	1693.5	3.3
% Change, Annual Rates	10.1	7.1	1.6	3.9	6.8		1.1	3.9	4.8	5.7	3.3	
Consumption	2276.5	2332.7	2361.4	2398.6	2342.3	8.6	2440.2	2481.5	2518.9	2571.1	2502.9	6.9
Durables	310.9	320.7	317.2	324.7	318.4	13.8	330.6	341.4	346.5	361.5	345.0	8.3
Non-Durables	841.3	858.3	861.4	872.1	858.3	7.1	882.5	890.4	899.8	911.5	896.1	4.4
Services	1124.4	1153.7	1182.8	1201.8	1165.7	8.5	1227.2	1249.7	1272.6	1298.1	1261.9	8.3
Investment	623.8	627.0	662.8	635.5	637.3	35.1	631.1	639.5	664.1	681.0	653.9	2.6
Non-Residential	398.8	420.8	435.7	448.9	426.8	28.7	454.8	460.5	466.8	474.5	464.2	8.9
Producers Durable Equipment	256.7	279.7	284.2	291.4	275.7	23.5	295.7	300.0	304.5	310.1	302.6	9.7
Structures	142.2	150.0	151.4	157.5	150.3	15.9	159.1	160.5	162.3	164.4	161.6	7.5
Residential	151.2	155.6	155.3	155.4	154.4	16.8	154.9	159.3	157.3	171.3	163.2	5.7
Inventory Changes	73.8	50.6	71.8	31.1	56.8		21.3	19.7	30.0	35.2	26.6	
Net Exports	−51.5	−58.7	−90.6	−64.3	−66.3		−78.0	−75.3	−74.7	−64.7	−73.2	
Government Purchases	704.4	743.7	761.0	782.7	748.8	9.1	800.4	814.8	829.0	845.4	822.4	10.0
Federal Defense	213.4	220.8	220.3	231.4	221.5	10.4	238.5	243.1	247.8	255.5	246.2	11.2
Federal Civilian	54.2	75.6	81.7	84.6	74.8	6.9	86.3	87.5	88.3	88.6	87.7	18.4
State & Local	436.8	447.4	458.9	466.6	452.4	8.8	475.6	484.2	492.9	501.3	488.5	8.0
Final Sales: $72	1579.3	1618.5	1614.6	1646.9	1614.8	5.0	1654.9	1672.2	1688.4	1710.6	1681.6	4.1
% Change, Annual Rates	3.6	10.3	−1.0	8.2	5.0		2.0	4.2	3.9	5.4	4.1	
Domestic Demand: $72	1619.2	1650.2	1672.2	1676.3	1654.5	8.7	1687.7	1703.4	1721.8	1740.9	1713.5	3.6
% Change, Annual Rates	12.9	7.9	5.4	1.0	8.7		2.8	3.8	4.4	4.5	3.6	
GNP Price Index (1972 = 100)	220.6	222.4	224.6	225.9	223.4	3.7	227.8	229.6	231.4	233.7	230.6	3.2
% Change, Annual Rates	4.4	3.3	4.0	2.4	3.7		3.4	3.2	3.2	4.1	3.2	
Consumer Price Index (1967 = 100)	306.8	309.6	312.3	315.3	311.0	4.2	317.9	320.4	323.0	326.1	321.8	3.5
% Change, Annual Rates	5.0	3.7	3.6	3.9	4.2		3.4	3.1	3.3	3.8	3.5	
Total Personal Income	2920.5	2984.5	3047.2	3100.4	3013.2	9.8	3134.2	3171.7	3223.7	3292.0	3205.4	6.4
Disposable Personal Income	2502.2	2554.3	2606.4	2649.4	2578.1	10.2	2683.7	2714.2	2756.7	2811.8	2741.6	6.3
Savings Rate	6.1	5.7	6.3	6.3	6.1		5.8	5.3	5.3	5.3	5.4	
Employment Rate	57.5	58.0	58.0	58.2	57.9		58.2	58.3	58.6	58.8	58.5	
Unemployment Rate	7.9	7.5	7.5	7.2	7.5		7.3	7.3	7.2	7.0	7.2	
Indus. Production (1967 = 100)	159.8	163.1	165.6	165.3	163.4	10.8	166.1	167.6	169.5	173.0	169.0	3.4
Housing Starts (000)	1968.0	1895.3	1663.7	1558.7	1771.4	4.8	1686.2	1812.0	1896.8	1902.9	1824.5	3.0
Domestic Auto Sales (000)	8162.3	8262.0	7966.7	7440.0	7957.8	17.1	8218.4	8345.2	8085.2	8422.9	8267.9	3.9
Corporate Pre-Tax Profits	243.3	246.0	224.8	222.9	234.2	15.3	213.2	223.8	234.3	249.7	230.2	−1.7
− Taxes	92.7	95.8	83.1	82.0	88.4		76.6	81.2	87.0	96.3	85.3	
Net Profits	150.6	150.2	141.7	140.9	145.8	14.5	136.7	142.6	147.2	153.3	144.9	−0.6
− Dividend Payments	77.7	79.9	81.3	83.0	80.5	10.4	84.4	86.6	88.9	91.4	87.8	9.1
Undistributed Profits	72.9	70.2	60.3	57.9	65.3	19.9	52.3	56.0	58.4	61.9	57.1	−12.5
+ Depreciation	287.5	296.4	306.4	317.2	301.9		327.1	337.2	347.1	358.0	342.3	
− Inventory Profits	13.5	7.3	0.2	1.7	5.7		2.9	2.0	6.1	13.0	6.0	
Net Cash Flow	346.9	359.3	366.5	373.4	361.5	17.5	376.5	391.1	399.4	406.9	393.5	8.8

Manufacturers Hanover completes another record year.

Extracted from a letter to shareholders by John F. McGillicuddy, Chairman.

"I am very pleased to report that our corporation's earnings reached a new high in 1984. In fact, our net income of $352.5 million represents this institution's 12th consecutive year of record results.

"Fourth quarter earnings totalled $106.2 million, an increase of 23 percent over last year's fourth quarter. Even more significant was the fact that our earnings per share for this period reached $2.14 up from $2.13 a year ago and $1.69 in the third quarter of 1984. This means that the dilution resulting from the issuance of common and preferred stock—both related to the acquisition of CIT Financial Corporation—has been reversed, and in only nine month's time.

"A major factor in this reversal was that CIT's performance more than lived up to expectations. Since it was acquired on May 1st, CIT has contributed $31.7 million to our bottom line—that, after all charges for interest-related financing costs and the amortization of the purchase premium. On a pro forma basis, had CIT been with us for the full year instead of only eight months, it would have contributed approximately $45 million. We expect CIT will contribute at an even higher level in 1985.

"Other highlights of the year worth noting include:

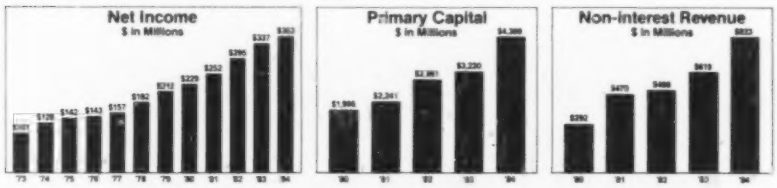
"A 35.7 percent increase in primary capital, up $1.2 billion to $4.4 billion. This brought our ratio of primary capital to assets to 5.77 percent, up from 5.01 percent a year ago. In the past three years, we have added $2.2 billion to our primary capital base.

"A $198 million addition to our reserve for possible loan losses. This 45.8 percent increase in our reserves came after absorbing a record $259.2 million in net loan charge-offs. This means that despite the impact of a grossly uneven economic recovery, both at home and abroad, we were able to absorb our losses out of current earnings even as we bolstered our reserve by an additional $198 million. At year's end, our reserve totaled $630.7 million, representing a ratio of reserves to total loans of 1.08 percent, up from .90 percent a year ago.

"A 33 percent increase in other operating income to $823 million. This $204 million improvement means that we continue to derive an ever-growing share of our revenues from fee-based services that make little or no claim on our capital ratios. Improvements came in virtually all sectors of our business, but were particularly strong in the areas of foreign exchange trading, securities trading and investment banking.

"On the international scene, progress continued to be made during the year, with a major debt restructuring for Mexico and with Argentina reaching agreement with the International Monetary Fund and major creditor banks. The result was a partial payment of past-due interest by Argentina at year's end. Despite this payment, our earnings for the year were reduced by $26.3 million after-tax by the impact of certain nonaccrual Argentine loans.

"Our strong performance in the fourth quarter, particularly given the challenges we faced, provides us with a great deal of momentum as we enter 1985."



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A full earnings report and complete financial statements are available pending publication of the 1984 Annual Report and 10-K in early March. Write Manufacturers Hanover Corporation, Corporate Communications Dept., 270 Park Avenue, New York, NY 10017.

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The Manufacturers Hanover
Economic Report

Irwin L. Kellner
Senior Vice President
and Economist

MARCH 1985

The Buck Stops—Where?

The continued strength of the U.S. dollar in foreign exchange markets has economists, corporate treasurers, and policymakers searching for explanations. To be sure, the original reason for the surge of investments into dollars—high real interest rates in the U.S. compared with other countries—still largely exists. However, the dollar's foreign exchange value has gotten so high that it has begun to exert a serious impact—not only on a number of key industries (Economic Report—December 1984), but on the U.S. economy as a whole.

This has led to several attempts by Washington and other world capitals to depress the value of the dollar by intervening in the foreign exchange markets. As you might have expected, these forays produced no lasting change in the dollar's value. Indeed, they may have contributed to strengthening the dollar by pointing up the difference in the amount of assets available to central bankers compared with those in the foreign exchange markets.

Intervention, of course, attacks symptoms rather than causes. Thus, concerted efforts by central bankers to depress the value of the dollar would work only if the markets were ready for a fundamental change in their attitudes towards the dollar. This change does not seem to have occurred just yet. For it would appear that real interest rate differentials are just the tip of the iceberg when it comes to factors behind the dollar's strength.

A Shift In The Flow Of Funds...

Because of these comparatively high rates of return, there has been an increase in investment funds coming in from abroad. While this inflow of foreign savings may have helped to ameliorate financial pressures in U.S. markets, they are by no means the only reason for the dollar's strength. Indeed, according to the Commerce Department's balance-of-payments statistics, (see table) total foreign net capital inflows last year were approximately the same as in 1981. By contrast, U.S. net capital outflows have declined dramatically during the past couple of years. Undoubtedly, whatever pulled in foreign savings also kept U.S. funds from going abroad. As noted earlier, high real interest rates no doubt played a role, but an analysis of the statistics would suggest that other factors entered into the picture as well.

SELECTED U.S. INTERNATIONAL TRANSACTIONS
Billions of dollars, seasonally adjusted
(Positive entries are inflows, negative ones are outflows)

	1981	1982	1983	1984(e)
CURRENT ACCOUNT BALANCE	**6.3**	**−9.2**	**−41.6**	**−96.6**
financed by:				
SELECTED CAPITAL ACCOUNT FLOWS				
Private Capital Inflows to the U.S.	**75.4**	**94.2**	**77.7**	**72.5**
Direct Investment	23.1	14.9	11.3	19.4
Security Purchases	10.1	13.5	17.3	21.0
U.S. Bank Liabilities to Foreigners	42.1	65.9	49.1	32.1
Private U.S. Capital Outflows	**−99.5**	**−123.9**	**−37.9**	**−2.5**
Direct Investment	−9.6	−4.8	−4.9	−0.5
Security Purchases	−5.7	−8.1	−7.7	−1.7
U.S. Bank Claims on Foreigners	−84.2	−111.1	−25.4	−0.4
All Other Capital Flows, Net	**17.8**	**38.9**	**1.8**	**26.6**

(e) First 3 quarters, annualized
Note: Numbers may not add up due to rounding
Source: Department of Commerce, *Survey of Current Business*

For one thing, American banks sharply reduced their new lending to foreigners. After growing by $111 billion in 1982, new bank claims on foreigners (mainly loans)

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increased by less than $300 million during the first three quarters of 1984. This more than offset the drop of $34 billion in new bank liabilities to foreigners (borrowings plus various types of deposit accounts) with the result that there was a turnaround of nearly $80 billion over this time span.

You don't have to look far to find the reason for this dramatic shift in the flow of funds. First there was the international debt problem. As you know, a number of countries experienced difficulties in servicing their debts beginning in 1982. As part of the workout process, they curbed their imports and took steps to boost their exports in order to run (or increase) a surplus on their trade accounts. Combined with reschedulings, which stretched out debt repayments over a number of years, this reduced the financing needs of these debtor nations. Another reason was the drop in oil prices, which cut the borrowing requirements of the oil-importing countries. Finally, the U.S. economy experienced faster growth than most other economies, and thus required more credit.

...For A Variety Of Reasons...

Obviously, the faster rate of growth in the United States than elsewhere offered greater opportunities for deployment of funds by others as well. These higher growth rates translated into an even higher rate of after-tax returns on investment because of the Economic Recovery Tax Act of 1981. ERTA raised the after-tax profitability of investment by liberalizing tax depreciation rules. Meanwhile, the Federal Reserve successfully convinced the financial markets that it was not going to monetize Washington's budget deficits and fuel inflation. Thus the real after-tax rate of return on investments was further enhanced.

To be sure, the combination of fiscal ease and monetary restraint did result in high interest rates—nominal as well as real—as I have noted in the past. However, financial deregulation and financial innovation made the U.S. economy much more resistant to high interest rates than it used to be. Financial deregulation eliminated the rationing effect which tended to cut back homebuilding at a fairly early stage in the recovery by allowing thrifts to pay more for deposits. At the same time, such financial innovations as variable-rate mortgages, by enabling the thrifts to maintain a positive spread between the cost of deposits and the returns on their loans, allowed them to deploy their funds profitably, further supporting residential construction—a mainstay of the U.S. economy.

It is this relatively new ability to grow rapidly at a noninflationary rate in the face of high interest rates that seems to be responsible for the turnaround in the international flow of funds. Reflecting better opportunities here than elsewhere, foreign net direct investment in the U.S. continues to run at high levels, while U.S. net direct investment abroad has dropped sharply. Insofar as indirect investment is concerned, foreigners have stepped up their purchases of U.S. securities while U.S. net purchases of foreign securities have declined as well. This is interesting, when you consider that U.S. citizens holding U.S. dollars have greater purchasing power abroad than foreigners with their currencies have here. It would seem that while foreigners are attracted to the enhanced after-tax rate of return available in the U.S., Americans may be pulling back from overseas investments because of the reduced rate of growth that exists outside the U.S.—not to mention the losses that occur when earnings in weak currencies are translated into strong dollars.

Focusing in on foreign economies for a moment, Japan, Germany, the United Kingdom, and a number of smaller European countries have been following fiscal policies diametrically opposite to those of the United States. Over the past several years they have been making strenuous efforts to reduce their budget deficits. Several have been successful—in particular, Germany, Japan and the United Kingdom. The problem is that these restrictive fiscal policies, along with comparatively tight monetary policies, have produced extremely weak economies. This is due in part to the speed at which these deficits were reduced and also because their savings rates are high—meaning no offsetting increase in spending by the private sector.

The Organization for Economic Cooperation and Development (OECD) reports that while the U.S. has been enjoying its strongest postwar recovery, the rest of the OECD area has been experiencing by far its weakest postwar upswing. This is ironic, considering that the reason these countries cut their budget deficits was to release funds to the private sector in order to lower interest rates and stimulate economic activity. However, while real interest rates overseas have generally fallen from their 1981 peaks and are now for the most part lower than that of the United States, they still remain unusually high, in view of the depth of the 1980-82 recession and the anemic nature of these countries' recoveries. These restrictive fiscal and monetary policies have only partially been offset by the strong stimulus other countries have been getting from their ability to sell more goods in the U.S. and other dollar-denominated markets.

...Is Keeping The Dollar Strong...

Therefore, as you can see, the strength of the dollar reflects a shift in financial flows due to a combination of developments both within and outside the United

States. While a major one—the shift by U.S. banks from net providers of funds overseas to net borrowers—may not persist, other factors leading to a scarcity of dollars outside the U.S. are likely to remain. As long as prospects for pre- and after-tax returns after taking into account potential currency changes look so much better here than in the rest of the world, the U.S. could continue to attract funds for quite some time to come. However, should the U.S. economy slow down and/or output rise more rapidly overseas, conditions favoring the dollar might well change.

Brighter prospects overseas might make foreigners less willing to invest in the U.S. and U.S. entities more interested in sending funds abroad—the costs and risks of foreign exchange notwithstanding. This would be especially true if other countries were to follow our lead and orient their policies toward high growth, low inflation, and reduced tax rates. Such a change is not impossible: Once other governments realize that their economic policies—instead of strengthening their currencies and their economies—are actually weakening them, they could easily reverse course.

Even before this happens, however, the direction of financial flows could change, for there is a limit to these capital inflows. Foreign investors cannot forever raise the share of their assets they put into dollar securities and investments. It is not clear what these limits are and when they are likely to be reached. What is less uncertain is that the U.S. has now become a net debtor for the first time in about 70 years. Its holdings of foreign assets are smaller than the foreigners' holdings of U.S. assets, requiring the U.S. to pay more in dividends and interest than it receives. This means we are now borrowing, not only to pay for our excess of imports over exports, but also to service our foreign debt—a situation similar to our domestic budget deficit, with its rapidly rising interest costs.

...But This Won't Last Forever

I suspect that these limits will be reached once people decide that they've got as much dollars as they care to hold, given current incentives. At that point, unless new incentives arise, the U.S. will have to stop going further into debt. Indeed, the U.S. will probably require a trade surplus just to pay its debt-service bill; it might have to run a current account surplus to reverse some of the damage that will be done to our foreign investment position and creditworthiness.

Obviously, running a current account surplus would mean that we would have to produce more than we consume. If we can get other countries to buy more of our goods than they're doing now, we will not have to restrain our domestic expenditures. Other countries might be willing to take more U.S. goods at current prices if their economies were to begin booming—something that plainly depends on their own decisions regarding fiscal and monetary policies. If we can't achieve enough of a surplus by getting others to buy more, we may have to buy less and that usually means recession. And if the current account deficit reduction is also accompanied by a fall in the value of the dollar, this will lead to a higher rate of inflation—which would push up the interest rates and probably produce a recession.

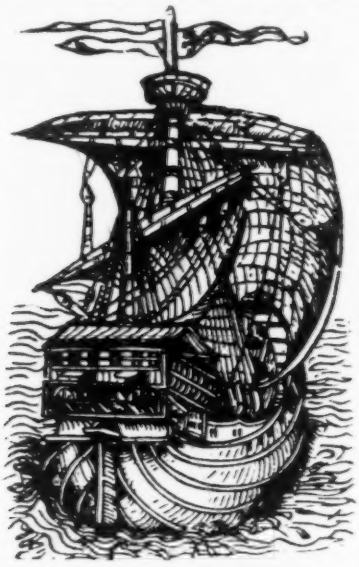
On the other hand, continued strengthening of the dollar could also produce a recession. A dollar that's even stronger than today would hurt more and more industries by making them unable to export and/or compete with imports. Eventually, enough industries would be declining to pull the entire economy down.

This is not to imply that there is no solution to today's version of the "dollar crisis." There is a way out—but it is not intervention, which is only temporary at best, and cosmetic at worst. Nor does it involve the U.S. deliberately screwing down its economy in order to dampen people's appetites for imports while reducing the price of goods we sell abroad. What it does require are fundamental changes in the U.S. economic policies and those of our trading partners. We must become more like them in some respects while they must become more like us.

Notice I said "in some respects." I don't mean that we should wind up growing more slowly and have more inflation like our trading partners overseas. What I think we should do, however, is to have a better balance between fiscal and monetary policy. This means, of course, reducing our budget deficit and offsetting it with a greater degree of monetary ease. Our trading partners, to offset the impact that our change will have on them, should ease their restrictive fiscal policies somewhat while keeping their monetary reins taut to hold inflation at bay. An easier fiscal stance abroad is feasible, given higher rates of private saving there than in the United States. These savings are available to finance the consequent rise in these countries' budget deficits from their current low levels.

The abnormally high value of the dollar is a symptom of a major disequilibrium in the world economy. It is the result of an inconsistent mix of monetary and fiscal policies being pursued by the United States and—in the opposite direction—by some of its major trading partners. To bring the dollar to a more appropriate level while minimizing the possibilities of either recession or inflation requires a better balance between monetary and fiscal policies both here and abroad—and a greater degree of cooperation and coordination between the major industrial economies of the West. H

Woodcut illustration from Columbus' letter to the Spanish Court, 1493



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